

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B02

PLR-147329-08

Date:

April 22, 2009

### Legend

X =

State =

D1 =

D2 =

D3 =

Y1 =

Y2 =

Y3 =

Y4 =

Y5 =

\$a =

\$b =

Dear \_\_\_\_\_ :

This responds to a letter dated October 30, 2008, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

### Facts

According to the information submitted, X was incorporated under the laws of State on D1, and elected to be treated as an S corporation beginning on D2. X's original business consisted of welding repairs.

In Y1, X sold most of its tangible personal property, and in connection with the sale, X entered into an agreement to lease to the buyer the real property used in X's original business.

In Y5, X became aware that during Y2, Y3, and Y4 it had received income that was potentially passive investment income in excess of 25 percent of its gross receipts. At the close of each of the Y2, Y3, and Y4 tax years, X had \$a of subchapter C earnings and profits. In Y5, X distributed \$a to its shareholders, and X and its shareholders executed an election under § 1.1368-1(f)(2) of the Income Regulations to distribute subchapter C accumulated earnings and profits first.

X represents that it, and its shareholders, have consistently treated X as an S corporation since D2.

X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and its shareholders consent to make any adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

### Law

Section 1361(a)(1) defines an S corporation, with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for such year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) terminates whenever a corporation (l) has accumulated earnings and profits at the close of each of

three consecutive tax years, and (II) has gross receipts for each of such tax year more than 25 percent of which are passive investment income.

Except as otherwise provided in subparagraph (C), §1362(d)(3)(C)(i) provides that the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(1) of the Procedure and Administration Regulations provides that “rents” means amounts received for the use or, for the right to use, property of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that “rents” does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in the active trade or business of renting property only if the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in a rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (excluding depreciation).

Section 1362(f) of the Internal Revenue Code provides, in relevant part, that if: (1) an election under § 1362(a) by any corporation was terminated under paragraph § 1362(d)(3); (2) the Secretary determines that the circumstances resulting in the termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1375 imposes a tax on the income of an S corporation that has accumulated earnings and profits at the close of a taxable year, and that has gross receipts more than 25% of which are passive investment income (within the meaning of § 1362(d)(3)).

Section 1375(b)(1)(B) provides that the amount of the excess net passive income for any taxable year shall not exceed the amount of the corporation's taxable income for such taxable year as determined under § 63(a)--(i) without regard to the deductions

allowed by part VIII of subchapter B (other than the deduction allowed by § 248, relating to organizational expenditures), and (ii) without regard to the deduction under § 172.

### Conclusion

Based solely on the representations made and the information submitted, we conclude that X's S election terminated on D3, because X had subchapter C earnings and profits at the close of each of three consecutive tax years, beginning in Y2, and had gross receipts for each of those years of which more than 25 percent was passive investment income.

We further conclude that the termination of X's S election was an inadvertent termination within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation on and after D3, unless X's S election is otherwise terminated under § 1362(d), provided that, within 60 days of this letter, X sends a payment of \$b with a copy of this letter to the following address:

Internal Revenue Service  
Cincinnati Service Center  
201 West Rivercenter Blvd.  
Covington, KY 41011  
Stop 31  
Terri Lackey  
Manual Deposit

If this condition is not met, then this ruling is null and void. Furthermore, if this condition is not met, X must send notification that its S election has terminated to the service center with which X's S election was filed.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of this transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X's S corporation was valid under § 1362.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Bradford R. Poston  
Senior Counsel, Branch 2  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures

A copy of this letter

A copy for § 6110 purposes